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C O N F I D E N T I A L SECTION 01 OF 03 FRANKFURT 000731

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TAGS: EFIN ECON EINV ETRD GM
SUBJECT: TREASURY DEPUTY SECRETARY KIMMITT MEETS BUNDESBANK PRESIDENT WEBER ON INVESTMENT, STATE OF THE ECONOMY, AND TRANSATLANTIC ECONOMIC ISSUES

Classified By: Pol-Econ Chief Daniel Froats for Reasons 1.4(b) and (d)

¶1. (C) SUMMARY. Deputy Secretary of the Treasury Robert Kimmitt met February 12 with Bundesbank President Axel Weber to review the state of Germany's economy, financial market regulation, and key transatlantic economic issues. D/S Kimmitt and Weber agreed on the need for open investment regimes while dealing with growing security concerns over vital infrastructure. Weber painted an upbeat picture of the German economy despite the recent value-added tax (VAT) increase, reflecting increased flexibility in the temporary job market, but warned that the German government's soon-to-be-proposed enterprise tax reform could represent a step backwards on key points including capital gains taxation (which would increase in many areas) and potentially retroactive increases in taxation of intangible transfers. On exchange rates (in particular the yen), Weber agreed that G-7 countries should let markets take the lead and only "jawbone" where members agree that an exchange rate is fundamentally misaligned. D/S Kimmitt explained the USG's current efforts to promote insurance portability and pension reform -- sometimes a political minefield -- in order to help U.S. workers flexibly adjust to the needs of a globalized economy. END SUMMARY.

¶2. (U) On February 12, D/S Kimmitt held a working lunch with Bundesbank President Prof. Axel Weber, who was joined by Bundesbank board member Prof. Hermann Remsberger and Wolfgang Moerke, head of international relations.

USG Engagement in Germany

¶3. (U) Weber opened by noting the USG engagement in Germany and the Frankfurt area in particular (for instance, the large U.S. Consulate General) and expressed his support for Chancellor Merkel's efforts to put the U.S.-German friendship back at the heart of German foreign policy. Weber also remarked on Ambassador Timken's engagement with Muslims, for instance in Berlin's large immigrant community; Treasury Deputy Secretary Kimmitt applauded the Ambassador,s outreach efforts and added that U.S. missions across Europe are reaching out to European Muslims to improve the U.S. image in that critical group. Weber noted that his wife hails from a largely Muslim area in Great Britain and that many British are perplexed at the radicalization of some Muslim youth despite having grown up in prosperous, "integrated" families.

Merkel's Transatlantic Initiative, Trade, and Investment

¶4. (C) Treasury Deputy Secretary Kimmitt noted that the Chancellor's transatlantic economic initiative is supported at the highest levels of the USG. Both side now emphasize

that the initiative should focus on non-tariff barriers and will not compete with Doha. Completing the Doha Development Round is a time-sensitive high priority; unfortunately, the EU is hampered by political uncertainty in key member states including France. The Chancellor's initiative -- led by key people in the USG, GOG, and European Commission -- is focused on regulatory regimes and ways to deepen our economic ties. We are looking towards the April 30 U.S.-EU summit as a key milestone in this initiative.

¶5. (C) D/S Kimmitt emphasized the importance of open investment regimes. The US and Germany are "shining examples" of countries who benefit both as sources and targets of large investment flows. Together we must ward off incipient "investment protectionism" on both sides of the Atlantic and in emerging markets. The USG is trying to publicize the fact that nearly all large foreign investment deals in the U.S. -- even those that incur a CFIUS review -- are handled expeditiously and without undue political overtones. Weber agreed, noting that key sectors in Europe (telecoms, energy) are opening up in line with EU pressure for more competition. Political complications tend to come from employment concerns, considerations over key network infrastructure, and/or concerns about Russian control of key assets. The Putin speech at Munich, coming on top of gas pipeline interruptions in recent months, will keep energy security and Russian financial interests on the minds of many Germans.

Foreign Exchange/Yen

¶6. (C) On exchange rates (in particular the yen), Weber recalled the past weekend's G-7 Finance Ministers' discussion on the issue, opining that it would have been wrong for

finance ministers to pressure Japan for a yen correction so soon after convincing Japan that it should let markets determine exchange rates. Rather, finance ministers should only try to use communiques to move rates on the rare instances where there a consensus on misalignment -- otherwise one will "inflate" that tool, making it less effective. The German government is under pressure (coming for instance from the higher-end automotive sector) to lobby for a stronger yen.

¶7. (C) D/S Kimmitt reviewed the U.S. position that markets should determine exchange rates. In the U.S. as well, the automotive sector and members of Congress whose constituents depend on that sector are vocal on the yen.

State of German, U.S. Economies

¶8. (SBU) Weber expressed optimism on the German and U.S. economies based on data so far this year. The German economy had weathered the 3% VAT increase in January well, although many are underestimating the effect on inflation (some businesses raised prices before January, whereas others chose to forego the traditional January sale). In the end, price effects will likely surpass one percent. First quarter GDP is looking to be essentially flat, not the -0.7% contraction many were predicting. Unemployment is down to 9.5% -- high by U.S. standards, but with the promise that continued recovery could mean jobs for another million German unemployed. Weber said Germany has the odd feature that its export-competing open sector (the "first labor market") remains heavily unionized and inflexible -- accounting for little job growth -- whereas growth is coming in the "third labor market" of temporary jobs through private employment agencies (the "second labor market" represents government-subsidized jobs). Such private firms who "rent" labor to growing companies have more flexible hiring/firing terms than industry itself and act as a springboard for talented individuals who later find direct employment in

industry/services. Germany's recovery could continue for another two or more years.

¶9. (SBU) D/S Kimmitt welcomed the new-found flexibility in the German labor market and noted that Americans probably lead the world in this respect: average job tenure is far shorter than in Europe, and Americans who change jobs usually move up in terms of wages and/or responsibilities. Flexibility has also brought uncertainty, however, leading the USG to look for tools to assist workers as they move. Health insurance portability is a key topic -- a challenge there is that U.S. states (not the federal government) regulate insurance.

Regulatory Reform, Tax Policy

¶10. (SBU) Citing the insurance sector, Remsberger noted that before the U.S. and EU can integrate their regulatory approaches, sometimes the U.S. must integrate its own disparate federal and state regulatory regimes. D/S Kimmitt replied that our first focus should be deregulation or minimally-necessary regulation. Rather than focus solely on harmonization, the U.S. and EU should work towards mutual recognition. In the U.S. case, the President's Working Group on Financial Markets -- a forum for independent regulators such as the SEC to discuss issues -- shows that even fiercely independent authorities can work together on mutually acceptable outcomes. Weber noted that Germany has its own problems with fragmented state jurisdictions, for instance in pensions and insurance.

¶11. (C) Weber criticized the German government's upcoming corporate/capital gains tax reform as a step backwards on key points despite a lowering of the "headline" corporate tax rate. For political reasons, the Grand Coalition has included measures to increase capital gains taxation (i.e. tax the wealthy more) in exchange for giving tax relief to companies. The GOG will increase the base for capital gains, which will particularly hit family-owned and independent entrepreneurs. Other measures would increase taxation of "intangible" transfers (for instance, intra-company) -- perhaps even with retroactive effect. The measures would come on top of the already-enacted increase in Germany's top rate of personal income taxation. Unfortunately, Germans fled the stock market after the 2001-2002 slump, meaning that most still view capital gains as an issue only for the rich. D/S Kimmitt opined that retroactive corporate tax law changes that hit international business would weigh heavily on Germany's attractiveness -- undermining the very purpose of

corporate tax reform.

¶12. (U) This cable was coordinated with Embassy Berlin, and Treasury Deputy Secretary Kimmitt has cleared this message.
POWELL